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Regulatory Takings, Supernational Treatment, and the Multilateral Agreement on Investment: Issues Raised by Nongovernmental Organizations

Edward M. Graham*

Introduction

It was only during the 1990s that the world of international trade and investment first seriously met with the world of the nongovernmental organizations (NGO). As first meetings go, it was not a happy one. The parties discovered that legal principles designed primarily to facilitate unfettered international movements of goods and services were not always compatible with the goals of the NGOs. Although these latter goals were rather diverse, they largely centered on one principle: the preservation of the "global commons."

An item belonging to the global commons consists of virtually any "good" held in common by the collective population of the planet where private ownership is not feasible. The technical term is that the good is "nonexclusive." Such goods include both tangible items, such as the air we breathe, as well as abstractions such as "biological diversity" or "basic human rights." Knowledge also falls into this category. For example, no one owns the theorem of Pythagoras. Although these latter "goods" might be abstractions, they have tangible impact on the quality of human life. Society, at least in democratic nations, places positive value on both categories of goods.

To maximize societal value of these goods, one should neither assign property rights to such goods nor trade them as if they are private commodities. Some goods might not be nonexclusive but society chooses by law to make them so. In the case of human rights, for example, property rights can be, and are, assigned: my rights are mine alone and not yours, and vice versa. But such rights should not, for moral reasons, be traded in a market. Society does not allow anyone to sell himself or herself into slavery. The true public good is the collectivity of individual rights, and this

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collectivity is nonexclusive. In other words, such goods have the attribute of being "public goods" *as per* the standard definition.

Some might object to calling basic human rights or preservation of biodiversity "public goods" because such matters raise moral issues that are beyond economic analysis. There are benefits to society at large in upholding human rights or in preserving endangered species. Market mechanisms cannot deliver these "untradable" benefits. Most economists and NGOs would endorse this proposition. Economic analysis might fail to define the value of these benefits. But the idea that these benefits do in fact exist is at the heart of both analytic and moral judgments that value does exist.¹

One characteristic of public goods is that they are free. One does not pay for the air one breathes, for one's basic civil rights, or for the right to use the Pythagorean theorem. The standard explanation for why these valuable goods are free is that they are "nonrival" goods. Use by one person does not deplete the good; that is, there is no binding supply constraint on the good. Alternatively expressed, satisfaction gained by one user of the good does not diminish the satisfaction of others. Where this characteristic breaks down — e.g., if the supply of breathable air is seriously threatened by contamination — there will arise the need to regulate or constrain usage.² Exactly how best to regulate such goods is subject to debate within the legal and economic communities. One method might be to assign quasi-property rights to these goods. For example, air pollution might be kept within acceptable bounds if pollution rights were issued, the total number of which would be set so as to keep contamination within tolerable limits. These rights could then be traded, thereby allowing the market to determine the most efficient use of such rights.

The earliest clash between NGOs and the world trading system took place within the General Agreement on Tariffs and Trade (GATT), now the World Trade Organization (WTO), over environmental protection issues. The Earth Island Institute sued the U.S. Commerce Department, seeking to ban importation of Mexican tuna caught by processes that, if used by U.S. fishermen, would have been illegal under the Marine Mammal Protection Act of 1972.³ This law requires the U.S. Secretary of Commerce to ban tuna imports from countries that did not take steps to prevent the killing of marine animals by tuna fishermen. The court held that the Commerce Secretary violated the environmental protection law and ordered a ban on

1. The major disagreement between the economist and the environmentalist over preservation of endangered species is largely one of valuation. Environmentalists often place an unbounded (i.e., infinite) value on such preservation, whereas economists point out that the value of everything, indeed human life itself, is subject to some upper bound. The latter does not imply, however, that an economist would necessarily stand shoulder-to-shoulder with a lobbyist for the oil industry who uses soft language to imply that the objectives of the environmentalist have little or no societal value.

2. Contamination of a public good is an instance of an "external cost," i.e., a cost that is created by an activity but that is not borne by the activity itself.

3. See *Earth Island Inst. v. Mosbacher*, 929 F. 2d 1449 (9th Cir. 1991).

Mexican tuna.⁴ Mexico then complained to the GATT. The GATT panel sided with Mexico and held that the ban violated GATT Article III. The panel threw out U.S. claims that the ban was consistent with GATT Articles XX.b and XX.c. This outcome angered leaders and constituents of environmentally-oriented NGOs, convincing many that world trade law is antithetical to environmental concerns, and that the goals of unfettered trade are fundamentally incompatible with the goals of environmental preservation.

Many international trade experts felt that the GATT panel decision exposed major weaknesses in GATT law. GATT law is designed to bring about gains from international trade and investment, i.e., to generate benefits. If there is some tradeoff between the benefits of trade (most of which are realized privately by individuals) and those benefits associated with the preservation of a public good, rationality would dictate that international trade law should recognize the tradeoff. Most trade experts, however, saw the weaknesses in world trade law as correctable rather than irreconcilable incompatibilities between world trade and the preservation of the global commons.⁵

Some NGOs share this view. Indeed, a major rift amongst environmentally-oriented NGOs emerged at the time of the debate over the passage of the Act to Establish a North American Free Trade Area (NAFTA) in late 1995 and early 1996. Certain NGOs argued that NAFTA should be rejected because it would lead to further environmental degradation along the U.S.-Mexico border. Other NGOs argued that NAFTA might actually benefit the environment if certain rules and enforcement mechanisms were created.

In 1997, a number of NGOs shifted their focus away from the WTO and toward the Organization for Economic Cooperation and Development (OECD) and its negotiation of a new Multilateral Agreement on Investment (MAI).⁶ At the time of this writing, the future of the MAI was highly uncertain. If completed, the MAI would be binding upon all ratifying nations. Although the OECD was the negotiating venue, participation in the MAI was not limited to OECD member nations.

I. International Investments

Many NGOs opposed the MAI. The objections ranged from concerns that international investment is associated with the inhumane exploitation of labor in developing countries to concerns that certain provisions of the MAI might vitiate environmental protection laws.

4. See *id.* at 1453.

5. Alas, no changes were made to the GATT in time to affect the 1998 ruling on the shrimp problem. This case reinforced the panel decision on the earlier tuna case both in terms of interpretation of existing WTO law and in terms of the anger it generated with respect to the inability of this law to deal with a global commons issue.

6. See generally Directorate for Financial, Fiscal and Enterprise Affairs, Organisation for Economic Co-operation and Development (OECD), *The Multilateral Agreement on Investment: The MAI Negotiating Text* (last modified Dec. 14, 1998) <<http://www.oecd.org/daf/cmisi/mai/negtext.htm>> [hereinafter *MAI Negotiating Text*].

This Article disagrees with these objections. The claim that international investment fosters inhumane treatment of workers is not supported by empirical analysis.⁷ That is not to say that specific instances of such exploitation do not exist. Countries that suppress the rights of workers to organize labor unions are also preferred production sites for certain international corporations. In sectors such as footwear and apparel assembly, these examples seem pervasive. In the aggregate, however, international investment contributes to rising wages and improved standards of living in host nations.

To ban international investment on grounds that it creates inhumane treatment of workers is akin to banning the automobile because it causes pollution, injury, and death — all of which are forms of societal costs that adversely impact the global commons. But the automobile also brings tangible benefits to individuals; otherwise, it would not be so ubiquitous. What one is left with is a tradeoff between benefits and costs. About all that the law can do is to maximize the benefits. For example, a regulation that requires vehicles to be equipped with the best possible technologies aims to improve safety and reduce emissions without imposing undue burdens on the production costs. We do not require in the interests of safety that every vehicle be armor plated.

Likewise, it would be irrational, and perhaps even cruel, if an effort intended to prevent the use of child labor under sweatshop conditions also blocked foreign direct investments that would elevate standards of living in impoverished areas of the world. Empirical evidence suggests that beneficial direct investments are far more prevalent than exploitative investments.

The same type of irrational fear of foreign direct investment exists among environmentalists. Environmentalists typically argue that foreign investors tend to seek “pollution haven” jurisdictions, where legal and enforcement standards with respect to environmental issues are minimal. They are concerned that especially dirty activities will concentrate in these areas. Empirical evidence, however, shows that the overwhelming majority of the world’s direct investment is not located in pollution havens; rather, it is concentrated in the high-income democracies and other jurisdictions that tend to have the highest environmental standards.⁸ Also, the vast majority of direct investment is in sectors that are not typically associated with high rates of pollution. Furthermore, the typical international investor uses the latest and best technologies in overseas activities, which tend to be the least polluting.

There is no doubt that there are many investments that raise valid environmental concerns.⁹ Pollution havens do exist and attract certain investments. The point is not that the concerns about these investments

7. See generally Edward M. Graham, *Trade and Investment at the WTO: Just Do It!*, in *LAUNCHING NEW GLOBAL TRADE TALKS* 205 (Jeffrey J. Schott ed., 1998).

8. See Daniel C. Esty & Bradford S. Gentry, *Foreign Investment, Globalisation, and Environment*, in *GLOBALISATION AND ENVIRONMENT* 141 (Tom Jones ed., 1997).

9. See, e.g., Peter Waldman, *How Suharto's Circle and a Mining Firm Did So Well Together*, *WALL ST. J.*, Sept. 29, 1998, at A1.

are invalid. Rather, it is that, to bring justice to the guilty, one surely would not wish to hang the innocent.

II. Regulatory Takings

NGOs are especially worried that the investor protection provisions, when used in conjunction with proposed dispute settlement procedures, might be antithetical to a host nation's environmental protection laws. One interpretation is that these provisions would treat a general class of governmental "regulatory takings" as expropriations. Under the MAI, expropriations are not banned, but they must be carried out on a nondiscriminatory basis, under due process of the law, for a public purpose, and with prompt and adequate compensation in an internationally convertible currency.¹⁰ NGOs contend that any regulatory taking — i.e., any reduction in the value of an asset or property — associated with the enforcement of environmental law could be interpreted as an expropriation and hence subject to compensation.¹¹ NGOs argue that such an interpretation would effectively nullify many environmental protection laws and regulations. Governments might be reluctant to enforce such law and regulation because of budgetary constraints.

The worries of the NGOs are bolstered by recent U.S. Supreme Court decisions that place property development rights of individual property holders¹² over the right of society to regulate land use for environmental purposes without compensating the land owners. Thus, NGOs worry that the U.S. takings doctrine could become the international norm via the MAI.

This concern goes beyond the question of whether the MAI should create a venue for international investors to seek compensation for regulatory takings. Also at issue is whether such an agreement should grant international investors what amounts to "supernational" treatment, i.e., treatment that is more favorable to a foreign investor than a similarly-situated domestic investor. Because domestic laws usually do not require a sovereign government to compensate a domestic investor for loss of asset value resulting from a regulatory taking, if such a taking was deemed an expropriation under the MAI, the MAI would grant supernational treatment to an international investor.

These specific concerns can be easily remedied within the MAI. There is no need to reject the MAI in its entirety to remedy specific deficiencies in expropriation provisions.

This Part of this Article discusses the MAI's controversial language on regulatory takings. It is not meant to be comprehensive in its coverage of either the legal or the economic issues raised by regulatory takings. Rather, this Part is meant to establish: (a) that the MAI language encompasses regulatory takings; (b) that compensation for such takings has a

10. See generally *MAI Negotiating Text*, *supra* note 6, art. IV(2).

11. Provisions similar to the MAI exist in NAFTA.

12. The term "property" in this instance means land.

reasonable economic rationale; (c) that similar rationale can be offered for other matters raised by multilateral trade law but are not subject to compensation provisions; and (d) that domestic law generally does not provide compensation for takings where the sovereign does not actually seize property or assets.

A. Historical Background

A "taking" is defined as any governmental action that has the effect of reducing the value of a private asset or property. The extreme case would be an actual seizure of title to, or possession of, a tangible asset or property by the government. Under the U.S. doctrine of eminent domain (similar law exists in most OECD nations), such a seizure is permitted if it is done for a public purpose. In most instances of eminent domain, the government seizes private land and improvements to build roads, airports, and other public infrastructure. Under the Fifth Amendment of the U.S. Constitution, the government must pay an adequate compensation to the private owner for the seizure.¹³

A less extreme example involves laws or regulations that reduce the value of a private asset or property. The enforcement of such laws or regulations will henceforth be termed a "regulatory taking" to distinguish it from actual seizure by the government. The latter is sometimes termed a "physical taking."¹⁴

The scope of the Fifth Amendment's Taking Clause has changed over time. During the early to mid-19th Century, courts consistently ruled that the Fifth Amendment protection extends only to governmental seizures of real property or tangible assets.¹⁵ By the turn of the century, during the so-called *Lochner* era,¹⁶ the U.S. Supreme Court used a combination of the Fourteenth Amendment and the Fifth Amendment to strike down a string of legislative actions, including the income tax, minimum wage laws, and labor laws. Under the Court's interpretation of these Amendments, virtually any change in the law or its application that altered property values, including the values of intangible properties (such as expected earning streams) could be construed as a taking of property. The Court's tactic was to strike down such legislation on Fourteenth Amendment due process

13. The Fifth Amendment states: "No person shall be . . . deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation." U.S. CONST. amend. V.

14. Regulatory takings are to be distinguished from "physical invasions" of a property by the government for a public purpose, e.g., the creation of an easement in a private holding of land for purposes of creation of a common water or sewer line or connection thereto. These are *de facto* physical takings (the land can be used only for the purpose stated in the easement) but title remains with the original owner. Compensation is typically deemed to be the benefit conferred on the owner by the service created by the line.

15. Interestingly, in colonial times, some states did not necessarily require compensation for physical takings, e.g., the taking of undeveloped land for construction of a public roadway. See Myra Duncan, *Property as a Public Conversation, Not a Lockean Soliloquy*, 26 ENVTL. L.J. 1095 (1996).

16. The *Lochner* era is named after *Lochner v. New York*, 198 U.S. 45 (1905).

grounds.¹⁷ The *Lochner* era was a period of judicial activism designed to stem a tide of (socially) liberal economic legislation.

During the New Deal era, new appointments to the U.S. Supreme Court ended the judicial activism and diminished the scope of takings. Thereafter, the Court upheld most economic regulations even if compensation for regulatory taking was not provided. Since the 1980s, there has been some reversion to the *Lochner* era regarding regulatory takings of real property.¹⁸ The new doctrine has generally not affected regulatory takings other than those involving land use. This has caused some commentators to suggest that there is now essentially a dual U.S. legal doctrine involving regulatory takings: one for regulation of land usage and another for regulation of all other forms of economic activity.¹⁹ This new doctrine jeopardizes some environmental protection laws, such as restrictions against development in wetlands or beachfronts.²⁰

B. Compensation for Regulatory Takings

When does a regulatory taking require compensation? The guiding principle, surviving from the *Lochner* era, seems to be a rule of "diminution of value." Under this rule, not all regulatory takings result in automatic compensation. The government is required to compensate the property owner only where the taking action "goes too far" in terms of reducing the value of the asset or property.²¹ To paraphrase Justice Holmes, the government could scarcely function if it had to compensate owners of assets or properties every time a new provision is added to law, or an old one struck from law.²² Thus, the "too far" rule is meant to provide a balance between the

17. The Court often indicated that the legislation as struck down would pose no Constitutional issue had such compensation been available. The Court was rather selective in what legislation it struck down. See generally Molly S. McUsic, *The Ghost of Lochner: Modern Takings Doctrine and Its Impact on Economic Legislation*, 76 B.U. L. Rev. 605 (1996).

18. Restrictions on building in wetlands and coastal areas are examples of such regulations.

19. See McUsic, *supra* note 17.

20. See *id.*

21. The "diminution of value" rule dates to a 1922 U.S. Supreme Court decision that held that the government can regulate the use of private property without compensation, to prevent harm, unless the regulation "goes too far" in reducing the value of the property. *Pa. Coal Co. v. Mahon*, 260 U.S. 393, 415 (1922). However, no clear definition was provided to establish when in fact the regulation had gone "too far." It is a commonly held belief that the 1922 ruling broke new ground in suggesting that a regulation could go too far. Prior to that time, most regulatory takings cases were treated under the "noxious use" or "harm" doctrine that held that there was no taking if a regulation controlled uses of assets or properties that were injurious to the health, morals, or safety of the community. Note that during the *Lochner* era, in order to qualify under the harm doctrine, a regulation had to pass two considerably high hurdles. The first is a "means/end" test to determine whether the regulation would accomplish its stated purpose of preventing harm. The second is a "cause/effect" test to determine whether a party that suffered a loss of property value actually caused the harm that the regulation was attempting to avert.

22. See *id.* at 413.

government's ability to govern effectively and the right of citizens to be protected from governmental excesses.

U.S. law does not provide a clear test to determine when the threshold of "too far" has been crossed. Given this vagueness, treatment of regulatory taking has not been wholly consistent. U.S. trial courts have awarded compensation even though compensation was denied in previous cases with similar circumstances. Likewise, U.S. appellate courts have awarded compensations that differ from that of the lower courts even though both are applying the same rule to the same set of facts.²³

The diminution of value rule can be criticized on purely economic grounds. There are two main arguments against the rule. First, because the "too far" test applies only to compensating the private costs of regulation without considering what might be the public benefits of this regulation, a government might fail to regulate against inappropriate uses of property. Second, the lack of compensation can lead to overzealous or excessive regulation.

Either of these arguments could lead to an inefficient economic outcome if an element of "moral hazard"²⁴ is introduced. A full review of the economic implications is beyond the scope of this article, but several observations pertinent to the MAI are noted in the following paragraphs.²⁵

Suppose the government suffers from what is commonly termed "fiscal illusion." That is, the government sees the costs and benefits of its actions as equal to the fiscal outlays or revenues produced by these actions. It is well established that the fiscal costs and benefits of a governmental action often deviate significantly from the true costs and benefits to society. Hence, "fiscal illusion" is likely to create outcomes that are sub-optimal to societal interests. The Gramm-Rudman requirement that subjects international trade agreements with the U.S. Government to fiscal tests demonstrates this illusion. For example, an increase in tariffs resulting in increased revenues to the Treasury would be seen as a benefit, even though standard economic analysis indicates that this increase often results in a net cost to U.S. society.

When a government is under fiscal illusion, it might fail to apply a regulation when the regulation produces a net social gain. That is, if the

23. See generally RICHARD A. EPSTEIN, *TAKINGS: PRIVATE PROPERTY AND THE POWER OF EMINENT DOMAIN* 1 *passim* (1985) (discussing a legal history of takings). More recent cases are cited in Thomas J. Miceli & Kathleen Segerson, *Regulatory Takings: When Should Compensation Be Paid?*, 23 J. LEGAL STUD. 749 (1994); McUsic, *supra* note 17. In particular, Miceli and Segerson discuss the economics of the 1992 Supreme Court ruling in *Lucas v. S.C. Coastal Council*, 505 U.S. 1003 (1992). The ruling, in the eyes of some analysts, creates a new precedent in the compensation for a regulatory taking and thus establishes the "new doctrine" described in the text.

24. Discussed *infra*.

25. See generally Lawrence Blume et al., *The Taking of Land: When Should Compensation Be Paid?*, 99 HARV. Q.J. ECON. 71 (1984); Louis Kaplow, *An Economic Analysis of Legal Transitions*, 99 HARV. L. REV. 509 (1986); WILLIAM A. FISCHER, *THE ECONOMICS OF ZONING LAWS* (1985); William A. Fischel & Perry Shapiro, *Takings, Insurance, and Michelman: Comments on Economic Interpretations of Just Compensation*, 17 J. LEGAL STUD. 269 (1988).

total benefits to society exceeded the total costs, the fiscal illusion would prevent the government from recognizing this benefit at all. Similarly, the NGOs worry that if the MAI were to allow foreign investors to seek compensation for regulatory takings, then governments would be reluctant to pass or enforce regulations, even if they create net benefits for the preservation of public goods.

The fiscal illusion problem would be eliminated if governments are able to use a full cost/benefit analysis when deciding whether to enforce the regulation. If so, compensation for regulatory takings would be efficient; only those regulations that create net social benefits would be implemented. Such compensation would also be just. The community should compensate individuals for their losses if the community chooses to inflict losses upon specific individuals.

An important qualification must be added because it bears especially on the MAI: If full compensation for private losses is required, then the issue of "moral hazard" should be taken into account. Moral hazard arises when property holders view compensation as a form of insurance against future regulatory takings. These property holders tend to overdevelop their properties, i.e., they would invest more than they would in the absence of compensation, because they know that there is a significant probability of future regulation.

For example, suppose that a risk-neutral investor would receive \$100 from property development if there were no future regulations but would receive nothing if future regulations were enacted. Suppose further, that the actual cost of property development is zero, but the investor must pay for the right to undertake this development in the absence of regulations. If regulation is enacted, it renders the right null and void. Finally, suppose that the investor estimates the probability of future regulation to be fifty percent.

If there were no compensation offered in the event of regulation, the investor would be willing to pay up to the expected value of the return – in this example, \$50 – for the right to develop the property. However, if full compensation were allowed, this same investor would be willing to pay as much as \$100. The moral hazard created by the insurance causes the investor to overinvest by as much as \$50.

In this case, it might be argued that compensation should be limited to \$50, which represents the expected return to development given the risk of regulation without insurance. Yet, even this would lead to moral hazard and overinvestment; the investor would now be willing to pay \$75 for the development right. Even so, it might be argued that the owner should be compensated for the uninsured, expected value of the property if the regulation were actually in effect. However, calculation of the "moral hazard" premium – the difference between what the investor would pay for the right to develop with or without full compensation in the event that the value of the developed property is reduced because of regulation – is not as easy as this example suggests. The example was premised on the investor having linear (i.e., risk-neutral) preferences towards uncertainty. Had

the investor been risk-averse, as is the normal case, the maximum amount that he or she would have been willing to pay for the right to develop would have been less than the \$50 expected value of the payoff. Also, it is difficult to assess the probabilities of the contingencies (in the example, the contingency is whether or not regulation would take place) in the absence of a well developed market for contingent claims. Indeed, the payoff to development in the event that no regulation takes place might be subject to considerable uncertainty. In short, where an efficient level of investment in property development is straightforward to describe in theory, it often is not so easy to calculate in practice.

Also, the cost/benefit analysis itself is easier to apply in the abstract than in reality. In most instances, a significant component of total cost or total benefit is likely to be "external" in nature and hence not easily measured. The transaction costs of performing the analysis are also likely to be substantial. Transaction costs, including costs of adjudication, are not limited to compensation based on cost/benefit analysis. Any approach to compensation for regulatory takings is likely to have significant transaction costs. Such costs must be included as part of the calculus of whether compensation leads to an economically efficient outcome.

Moral hazards and transaction costs show that compensation for regulatory takings does not result in efficient outcomes, even if the government applies a cost/benefit analysis to determine what regulations to apply. Moral hazard can be reduced if compensation is based on estimates of costs to individuals in the absence of insurance. While various schemes for such a reduction have been proposed, without accurate and objective valuation, any such scheme could be challenged as to the value of the estimation and hence increase transaction costs.²⁶

Many economists worry that if governments act under fiscal illusion and, under the diminution of value rule, are not required to compensate for the loss of property value as the result of a regulatory taking, governments will regulate zealously. This is so because the costs of regulation will be perceived as zero, and regulation will be undertaken whenever it is perceived to be beneficial. In the strictest sense, this would occur only if the regulation were to produce revenue for the government. For example, during the 19th century, the U.S. government zealously regulated international trade via tariffs because it relied upon the tariff as its major source of revenue. In a classic work, Harvard economist Frank Taussig showed that the welfare costs of this reliance — resulting in a rather extreme form of fiscal illusion — were enormous to the United States.²⁷

It is even more problematic if governments suffer from some form of asymmetrical fiscal illusion. For example, a government might only treat direct fiscal costs as costs of regulation and anything that pleases a vocal constituency view as a benefit. Under these circumstances, applying the

26. The author, who is not a lawyer, cannot resist adding that this would likely create a new gold mine for the legal profession.

27. See generally FRANK W. TAUSSIG, *THE TARIFF HISTORY OF THE UNITED STATES* 1 *passim* (1892).

diminution of value rule to compensate only in exceptional cases would likely result in significant overregulation. This is so because most regulation would then be seen as costless and hence would be pursued if there is any perceived benefit. The regulation is excessive in the sense that it would lead to an inefficient outcome because real costs would be ignored.

III. MAI's Investment Protection Provisions

The specific language of the draft MAI that raises concerns about potential treatment of takings is contained in Article IV(2.1):

2.1 A Contracting Party shall not expropriate or nationalise directly or indirectly an investment in its territory of an investor of another Contracting Party or take any measure or measures having equivalent effect (hereinafter referred to as "expropriation") except:

- a. for a purpose which is in the public interest,
- b. on a nondiscriminatory basis,
- c. in accordance with due process of law, and
- d. accompanied by payment of prompt, adequate and effective compensation in accordance with Articles 2.2 to 2.5 below.²⁸

The phrase "measures having equivalent effect," combined with the adjective "indirectly," would make it easier for an international investor to allege regulatory taking. To expropriate or nationalize "directly" would seem to imply physical taking. However, if to expropriate or nationalize "indirectly" is interpreted to mean that some portion of the value of an asset passes to public ownership, even if actual title to the asset or property remains in private hands, then a regulatory taking could reasonably be interpreted as a measure "having the equivalent effect" of such an indirect nationalization. In other words, the phrasing of the provision is sufficiently ambiguous that a regulatory taking could be interpreted as an "indirect" expropriation or nationalization. In this event, an international investor who suffers a loss of property value could lodge a claim against the state under the MAI, if any of the four qualifying exceptions to article IV(2.1) are not met. If successful, the investor would be entitled to prompt and adequate compensation.

The MAI does not balance the right of governments to govern against the right of property holders to be protected from overzealous regulation. Indeed, the MAI's language could give rise to a taking claim even in cases where the government is acting to prevent harm. If this language does apply to regulatory taking, then the MAI, in effect, establishes a strict compensation rule, whereby such takings must be compensated regardless of circumstances.

Under such an interpretation, strict compensation would exacerbate the aforementioned moral hazard problem. If the MAI is interpreted to mean that compensation must be offered for regulatory taking, then such compensation would be tantamount to mandatory insurance in favor of investors against the risk of regulations. As previously discussed, this

28. MAI *Negotiating Text*, *supra* note 6, art. IV(2.1).

would lead to overinvestment in such projects. This overinvestment problem could be especially serious for nations that currently have lax labor or environmental standards.

Provisions in Articles IV(2.2) through IV(2.5) of the MAI increase the risk of a moral hazard. These provisions clarify terms on which compensation must be offered:

- 2.2 Compensation shall be paid without delay.
- 2.3 Compensation shall be equivalent to the fair market value of the expropriated investment immediately before the expropriation occurred. The fair market value shall not reflect any change in value occurring because the expropriation had become publicly known earlier.
- 2.4 Compensation shall be fully realisable and freely transferable.
- 2.5 [Compensation shall include interest at a commercial rate established on a market basis for the currency of payment from the date of expropriation until the date of actual payment.] (Note: the brackets indicate that this language was not agreed by all negotiating parties.)²⁹

Article 2.3 seems to suggest that compensation must be offered at the full value of the investment prior to public knowledge of the new regulation. The problem with this provision is that it would have the effect of insuring the investor against the risk that an internationally acceptable standard would be implemented.

Notwithstanding the fact that empirical evidence shows that most international investors do not flock either to "pollution-haven" nations or to nations with lax labor standards, some foreign direct investments, however, do take place in these countries. By encouraging overinvestment in such countries' labor-intensive or pollution-intensive industries, the MAI expropriation provisions would only serve to worsen the current problem.

The MAI establishes a standard that is more "friendly" to plaintiffs than the standard established under U.S. takings doctrine. Thus, under the MAI, foreign investors would be granted "supernational" treatment because they would have recourse to compensation not available to U.S. investors under comparable circumstances.

Although there are arguments both for and against compensation for regulatory takings, there are equally compelling arguments for compensating other categories of losses resulting from international commercial transactions where international law does not mandate such compensation. The very opening of an economy to international trade alters the value of the human capital in that economy. Yet, when trade liberalization causes owners of human capital to suffer losses, no world trade laws compensate these owners.

To be sure, recourse to compensation is provided under GATT article XXIX (also known as the "escape clause"), whereby temporary relief may be granted to activities that suffered "material injury" due to implementation of WTO obligations by member nations. Arguably, the possibility of compensation is also provided under GATT article VI, whereby exporters

29. *Id.* art. IV(2.2)-(2.5).

of "dumped" goods may be subject to tariff-like fines to equalize the margins of dumping where domestic producers of like goods suffered "material injury." As with the diminution of value rule, the rules underlying the implementation of these two articles can also be criticized on economic grounds for producing inefficiencies.³⁰ These rules have spotty coverage. Some individuals who suffer losses resulting from liberal trade are compensated while others receive no compensation at all. Also, unlike the MAI, these WTO articles do not provide international arbitral venues for gaining compensation. Rather, compensation must be sought via a national government operating within the context of the WTO rules.

Foreign investors would be in an uniquely privileged category if the MAI provides them with compensation for losses resulting from regulatory takings. Unlike most other categories of property holders who suffer losses from the regulation (or deregulation) of international commerce but are not entitled to compensation, international investors who are covered by MAI rules would be so entitled under virtually all circumstances. One can reasonably wonder why one category of asset holders should be entitled to such a unique privilege. Most of the same arguments advanced in favor of regulatory takings compensation on efficiency grounds apply equally to workers whose skills are devalued by changes in trade policy.

MAI negotiators recognized some of the problems associated with the regulatory taking provision under the MAI draft. At meetings held in early 1998, negotiators expressed views that MAI signatory governments were

not meant to be required to pay compensation for losses which an investor or investment may incur through regulation, revenue raising, and other measures of general application taken by governments, and that laws establishing taxation measures, environmental or labour standards, or intellectual property regimes, are not intended to constitute expropriation for the purposes of the MAI.³¹

Accordingly, the MAI negotiation committee chairman proposed changes to the MAI draft in March of 1998.³² Furthermore, the OECD declared that "the MAI would establish mutually beneficial rules which would not inhibit the normal non-discriminatory exercise of regulatory powers by governments[.]"³³

The current MAI draft, however, has failed to incorporate any of these changes. This failure might be a good thing because the OECD language would provide a complete carveout for regulatory takings. This provision is analogous to going from one extreme to another. There might be circumstances wherein one would want the expropriation provisions of the MAI to

30. This is especially so regarding antidumping. Most analysis suggests that the result is overcompensation in a form that unduly penalizes users of the goods.

31. Correspondence from Pierre Poret, Principal Administrator of Directorate for Fiscal, Financial, and Enterprise Affairs, OECD, to author.

32. See OECD, *Environment and Labour in the MAI: Chairman's Proposals* (visited Mar. 15, 1998) <<http://www.oecd.org/daf/cmism/mai/labeenv.htm>>.

33. OECD Ministerial Conference on Electronic Commerce, Oct. 7-9, 1998.

cover a regulatory taking, for example, where the intended effects of seemingly routine regulation were in fact discriminatory.

The history of investor protection provisions in international agreements indicates that their main purpose is the protection of foreign investors from discrimination by the host nation. U.S. negotiators recognize the importance of this protection, given that foreign investors have no recourse to an impartial judicial or corrective system. U.S. negotiators are especially worried about developing nations that expropriate U.S. investments without compensating subsidiaries of U.S. based corporations.³⁴ Such expropriations, or "forced divestitures," amount to physical takings.

In the late 1970s, the United States Trade Representative (USTR) entered into bilateral investment treaties (BITs) with developing nations. By providing for international arbitration of compensation disputes, forceful investment protection provisions in the BITs helped eliminate discrimination against U.S. investors abroad.

The investor protection provisions of the MAI are modeled after the BITs. Although useful in bilateral agreements, the utility of including such provisions is unclear in the case of a multilateral agreement, such as the MAI, which would be drafted and entered into by advanced nations with developed legal systems that provide protection to foreign investors. The judicial asymmetry that necessitates the investor protection provisions of the BITs does not exist in a multilateral agreement like the MAI.

If investor protection provisions cover regulatory takings, then international investors would gain the privilege of seeking claims for all regulatory takings. These privileges, however, are likely to arouse domestic resentment because foreign investors will be treated more favorably than nationals. A backlash of isolationism and mercantilism could follow.

A multilateral agreement should strive to achieve a minimal standard for investor protection that is consistent with internationally recognized standards, national treatment (i.e., non-discrimination), and due process. Investor protection provisions should not force a government to grant foreign investors compensation for regulatory takings beyond the level of compensation available to domestic investors. The current investor protection provisions of the MAI should therefore apply to physical takings only.

However, where a host nation applies its regulations in a highly discriminatory manner so as to create a *de facto* expropriation of a foreign asset or a significant diminution of this asset, the MAI should include a new provision that would protect the investor. As a safeguard against overzealous invocation of this provision, the MAI should require that an international tribunal find that the regulation is significantly prejudicial against the investor (i.e., that national treatment had been denied) or that due process of law had been denied. Absent such findings, the complaint should not be covered by the investor protection provisions.

34. See FRED C. BERGSTEN ET AL., AMERICAN MULTINATIONALS AND AMERICAN INTERESTS 385-95 (1978).

Conclusion

On October 14, 1998, after the preceding sections of this Article had been submitted to this Journal, French Prime Minister Lionel Jospin announced that France would pull out of the MAI negotiations because of continuing irresolution of issues pertaining to cultural industries and unbound reservations. Most observers felt, however, that the pullout actually stemmed from Jospin's need to placate his Socialist-Communist coalition to maintain his party's "cohabitation" with the rightist presidency of Jacques Chirac. The Socialist-Communist coalition vocally opposed the MAI, whereas Chirac's constituencies seemed indifferent to the fate of the MAI. On October 20, 1998, OECD Deputy Secretary General Joanna Shelton announced that, while there remained a consensus among OECD member nations on the need for a multilateral framework on investment in spite of the French pullout, negotiations on the MAI would resume as scheduled.

Should the negotiations never resume, the NGOs can take credit for stopping the MAI. The NGOs consistently maintained that the MAI would harm the environment. French leftists echoed this concern. As noted in this Article, it is not at all clear that the MAI would have the deleterious effects on the environment as the NGO critics claim. The MAI contains provisions similar to that of the NAFTA. And, contrary to the NGOs' assertion, multinational firms have not used these provisions as the basis for a wholesale attack on laws and policies designed to protect the environment in NAFTA nations. Even the pro-corporation outcome of the Ethyl case has not to date provoked a rash of similar cases, as environmentalists have feared it would. These provisions, however, grant foreign investors recourse to takings procedures that are unavailable to domestic investors under the NAFTA or OECD. Possibly the most objectionable aspect of the MAI is this supernatural treatment of foreign investors.

But it is also clear that OECD governments recognized this objection and were prepared to modify the MAI's expropriation provisions so that they would not apply to most takings. Indeed, when MAI negotiations were suspended in May of 1998, several negotiating parties (including the U.S. government) had signaled a willingness to amend the MAI to protect environmental and labor interests. To be sure, other issues remained unresolved, but such lack of resolution is typical of international negotiations. For example, some issues under negotiation during the Uruguay Round remained unresolved even as the final agreement was signed and came into force. These issues later became the core of the current WTO "built-in agenda." Traditionally, negotiations of multilateral trade agreements would take unresolved issues off the table so that these issues would not derail the whole train. Thus, if the MAI negotiations do end in complete failure, it will be unprecedented in the history of post-World War II multilateral trade negotiations.

The cause and effect of this failure is beyond the scope of this Article. About all that can be said is that the NGOs might have won a Pyrrhic victory in this instance, given that the MAI might have addressed many of their concerns. As matters stand, few of their concerns are addressed in

current WTO law. Moreover, failure of the MAI could render trade negotiations more suspicious of NGOs. These negotiations often perceive NGO goals as being the "upset the apple cart" variety rather than ensuring that the apples are safe to eat.

If nothing else, the MAI negotiations demonstrate that when the world of the NGOs meets the world of trade negotiations, the outcome is less than constructive. If the MAI does in fact fail, it is probable that the same issues will arise again in future WTO negotiations. One would hope that, by then, these two worlds will have learned how to deal with each other to reach a better outcome.